

BLUEPRINTS FOR BASIC TAX REFORM

Chapter 1

INTRODUCTION AND SUMMARY

OVERVIEW

There has been increasingly widespread dissatisfaction in the United States with the Federal tax system. Numerous special features of the current law, adopted over the years, have led to extreme complexity and have raised questions about the law's basic fairness. Many provisions of the code are, in effect, subsidies to certain types of taxpayers, or to particular interests, for some forms of investment and consumption. These subsidies are rarely justified explicitly and, in some cases, may even, be unintentional. In many instances, they alter the pattern of economic activity in ways that lower the value of total economic output. Further, although the Federal tax system by and large relates tax burdens to individual ability to pay, the tax code does not reflect any consistent philosophy about the objectives of the system.

Previous efforts at tax reform have not attempted a thorough rethinking of the entire tax structure. As a result, reform legislation over the past 25 years has consisted of a series of patchwork palliatives, leading to a tax system increasingly difficult to understand. Indeed, the Tax Reform Act of 1969 has been referred to as the "Lawyers and Accountants Relief Act," and the Tax Reform Act of 1976 deserves this sobriquet no less. The confusion and complexity in the tax code have led Secretary of the Treasury William E. Simon to suggest that the Nation should "have a tax system which looks like someone designed it on purpose."

The first part of this report is devoted to clarifying the goals of the tax system, attempting to give specific content to the universally recognized objectives of equity, efficiency, and simplicity. Based on this analysis, two alternative conceptions of an ideal tax system are adopted to form the basis for practical reform plans. The report presents two model plans, comprehending both the individual and corporate income taxes, which demonstrate that the tax system can be made more equitable, easier to understand and justify, and more conducive to the efficient operation of the private economy.

Both plans have the general effect of broadening the tax base -- the measure of income to which personal exemptions and tax rates are applied. This, is the result of including in the base items excluded from tax under current law. This permits a simpler code in that elaborate rules are no longer required for defining items of tax preference or for protecting against the abuse of such preferences. Under either plan, the revenues currently collected from individual and corporate taxpayers could be raised with a substantially lower rate structure. In turn a lower rate structure would mitigate the distorting effects of taxes on economic decisions.

The alternative proposals for tax reform are: (1) a comprehensive income tax, and (2) a consumption base tax, called a cash flow tax. Both proposals seek to treat individual items in the tax code in ways that would achieve consistency with an ideal base, departing from the ideal only when necessary for administrative feasibility, simplicity, or compelling economic or other policy reasons. When concessions are suggested, they are identified as such and justification is provided.

The differences between the proposals derive from their underlying concepts of the tax base. The comprehensive income tax proposal is based on a broad concept of income that is defined in terms of the uses of an individual's receipts. According to this definition, an individual's income can be allocated either to consumption or to increasing his wealth (net worth). Because all increments to wealth constitute income, this approach is sometimes called an accretion concept. The cash flow tax assesses tax burdens on the basis of consumption, excluding from the tax base all positive and negative changes in net worth.

Both proposals deal with the major areas in which changes from the current tax code merit consideration. In all cases where there are ambiguities about defining consumption or change in net worth as components of income, or where the benefits achieved by exclusions or deductions from income under the current law appear to merit continued consideration, specific policy judgments are made for the purpose of presenting complete proposals. The report identifies the features of each proposal that are essential to the definition of the ideal tax base, distinguishing them from elements that can be handled differently and still remain consistent with a reasonable definition of either the comprehensive income or consumption tax base. The table at the end of this chapter compares the major features of the model tax reform plans with the current tax system.

This study shows that it is feasible to have a broadly based tax that departs in major ways from the current tax law. In providing specific alternative plans, the report sets out a guide for future legislation aimed at sweeping tax reform. It also points out some of the major policy issues that remain to be resolved. In presenting a plan for a tax system based on the consumption concept, the report points toward a promising alternative approach to tax reform that is not as different from our present system as it might seem and that, if consistently implemented, should provide major advantages in fairness, simplicity, and economic efficiency.

COMPREHENSIVE INCOME TAX

Proposals to adopt a more comprehensive definition of income in the tax base have received the most attention from tax reform advocates.

As previously stated, income may be viewed as the sum of consumption and change in net worth in a given time period. Although income is thus defined conceptually in terms of uses of resources, it is not practical to measure an individual's annual income by adding up all of his individual purchases of consumer goods and the change in value of all the items on his balance sheet. Rather, the measurement of income is accomplished by using the accounting notion that the sum of receipts from all sources within a given time period must equal the sum of all uses. To compute income, it is necessary simply to subtract from sources expenditures that represent neither consumption nor additions to net worth. These expenditures include the cost of operating a business (payment of salaries, rent, interest, etc.), or the direct cost of earning labor income (union dues, work clothing, etc.). They may include other specified expenditures, such as interest, charitable contributions, State and local income and sales taxes, and large nondiscretionary medical expenditures.

Because of exclusions, deductions, and shortcomings in income measurement rules, the tax base under current law departs from this comprehensive concept of income. For example, State and local bond interest and one-half of realized capital gains are not included in the tax base. On the other hand, corporate dividends are included in the tax

base twice, once at the corporate level and once at the individual level. In some cases, rules for tax depreciation allow deductions in excess of actual changes in asset values. When this occurs, business income is understated, and the taxpayer has increase in net worth that goes untaxed.

In setting out a practical plan to achieve equity, simplicity, and efficiency in the tax system, the model comprehensive income tax follows a broad concept of accretion income as a guide. The major features of the model comprehensive income tax are summarized below.

Integration of the Corporation and Individual Income Taxes

A separate tax on corporations is not consistent with an ideal comprehensive income tax base. Corporations do not "consume" or have a standard of living in the sense that individuals do; all corporate income ultimately can be accounted for either as consumption by individuals or as an increase in the value of claims of individuals who own corporate shares. Thus, corporations do not pay taxes in the sense of bearing the burden of taxation. People pay taxes, and corporate tax payments are drawn from resources belonging to people that would otherwise be available to them for present or future consumption.

It is difficult, however, to determine which people bear the burden of corporate tax payments. In a free enterprise system goods are not produced unless their prices will cover the costs of rewarding those who supply the services of labor and capital required in their output as well as any taxes imposed. The corporation income tax thus results in some combination of higher relative prices of the products of corporations and lower rewards to the providers of productive services, and it is in this way that the burden of the tax is determined. In spite of many attempts, economists have not succeeded in making reliable estimates of these effects, although a substantial body of opinion holds that the corporation income tax is born by all capital owners in the form of lower prices for the services of capital.

The two major advantages of integrating the corporate and personal taxes are that (1) it would eliminate the incentive to accumulate income within corporations by ending the double taxation of dividends, (2) it would enable the effective tax rate on income earned within corporations to be related to the circumstances of individual taxpayers.

Under the model comprehensive income tax, the integration of corporate income with the other income of shareholders is accomplished by providing rules to allocate all corporate income, whether distributed or not, to individual shareholders. Corporate distributions to shareholders are regarded simply as a change in the composition of investment portfolios -- that is, a portion of each shareholder's equity claims is converted to cash -- and have no tax consequences. Under this "full integration" plan, corporation income is fully taxed at the rates appropriate to each shareholder.

For this reason, the model plan eliminates the corporation income tax. The possibility of having corporations withhold taxes on behalf of shareholders, in order to alleviate problems arising when tax liabilities exceeded corporate cash distributions, is examined. It is emphasized that full integration is proposed in the context of a plan that attempts to tax equally income from all sources. "Dividend" integration such as that proposed by the Ford Administration in 1975, which represents, in itself, a desirable change in the absence of comprehensive reform, may also be considered as a transition to the model treatment of corporate income.

Treatment of Capital Gains and Losses

Under the broadest concept of a comprehensive tax base, capital gains that represent an increase in real wealth would be taxed even though not realized by sale or exchange of the asset. Similarly, capital losses, whether realized or not, would be subtracted in full from all sources of income in computing the tax base. The proposal moves in that direction by adopting the integration concept. Full integration provides a practical method for taxing increases in asset values arising from corporate retained earnings, a major source of capital gains in the current system. Capital gains realized upon sale or exchange of assets are taxed fully under the model plan after allowing a step-up in basis for inflation. Because maximum tax rates would be considerably lower if a comprehensive tax base were adopted, there is far less reason for special treatment of capital gains to achieve rough averaging effects in a progressive rate structure. Realized capital losses are fully deductible against ordinary income in the model system.

Thus, the proposal, while ending the current provision for exclusion of one-half of capital gains from the base, will also end the taxation of purely inflationary gains and eliminate current limits on deductibility of realized capital losses. Compared with present law, taxation of capital gains would be lower during periods of rapid inflation and possibly somewhat higher during periods of relative price stability. The proposal does not recommend taxation of gains as accrued (that is, prior to realization) because the administrative cost of annual asset valuations is prohibitive and because otherwise taxpayers might face problems in making cash tax payments when no cash had been realized. The corporate integration proposal would enable the largest part of individual income previously reflected in realized capital gains to be taxed as accrued by eliminating the corporate tax and taxing corporate income directly to the shareholders, whether or not it was distributed. This is a fair and workable solution.

Depreciation Rules

The proposal defines some general principles for measuring depreciation of assets for tax purposes. It is recommended that a systematic approach to tax depreciation, perhaps one modeled after the present Asset Depreciation Range System, be made mandatory for machinery and equipment and structures. A set of accounting procedures would be prescribed that would provide certainty to the taxpayer that his depreciation allowances would be accepted by the tax collector and would reasonably approximate actual declines in the value of these depreciable assets. Cost depletion is recommended in place of percentage depletion for mineral deposits, as a better measure of the income arising from these properties.

State and Local Bond Interest

The proposal suggests that interest from state and local bonds be treated like all other interest receipts in the computation of the tax base, on the grounds that those receipts can be used for consumption or increases in net worth. Transition problems relating to existing bond holdings are recognized. The implicit tax burden in ownership of state and local bonds resulting from their lower interest yield is identified and evaluated. The report mentions alternative, less-costly ways of providing the same subsidy to state and local governments as is presently provided by the interest exemption.

Imputed Income from Consumer Durables

Under the broadest form of comprehensive income base, the imputed return in the form of the rental value of consumption services from ownership of consumer durables would be taxed. The exclusion of this form of income from tax provides an important benefit to home owners. They have invested part of their net worth in their home, rather than investment assets, but the value of the use of their home (the income it produces) is not taxed. This is particularly true when, as under our present system, interest on home mortgages is deductible from other income. This proposal does not recommend taxation of the imputed value of the use of homes and consumer durables because of difficulties of measurement. However, it is recommended that the deductibility of local taxes on noncommercial property, including owner-occupied homes, be reconsidered, on the grounds that this amounts to exclusion of more than the income that would be imputed to such assets.

Itemized Deductions

The report considers options for the treatment of major deductions, including deductions for medical expenses (which could be replaced with a catastrophic insurance program), charitable contributions (which could be eliminated or retained in the same form, without compromising the basic integrity of either the comprehensive income or cash flow tax), state and local income taxes (which would remain deductible) and sales taxes (not deductible) and casualty losses (not deductible). Decisions as to whether, and in what form, major personal deductions should be maintained depend on whether or not these expenditures should be viewed as consumption and on whether or not particular types of activities ought to continue to be encouraged through the tax system. The report presents specific proposals for treatment of major deductions but it is noted that other rules are also consistent with the concept of a comprehensive income base. The deduction of interest is maintained, as is, in modified form, the deduction of child care expenses. The report recommends elimination of the standard deduction, which will be replaced in part by more generous personal exemptions.

Retirement Income and Unemployment Compensation

Under a comprehensive income tax, both contributions to retirement pensions and the interest earned on such contri-

butions would be included in the base. However, a roughly equivalent result is achieved by taxing earnings on pension funds as they accrue and retirement benefits as received and allowing employer and employee contributions to pensions to be deducted from the tax base. This procedure is preferable because it minimizes problems of income averaging. Rules for making different types of pension accounts conform to this principle are outlined in the report. It is proposed that deduction of both employee and employer contributions to Social Security be allowed and that all social security retirement benefits be included in the tax base. The report also recommends that unemployment compensation payments be included in the tax base.

Liberal personal exemptions recommended will insure that persons with very low incomes are not taxed on social security benefits or unemployment compensation.

Choice of a Filing Unit and Exemptions for Family Size

The decision on the appropriate filing unit represents a compromise between objectives that are mutually exclusive under a progressive tax: a system in which families of equal size and income pay equal taxes and a system in which the total tax liability of two individuals is not altered when they marry. The report recommends continuation of family filing, with separate structures of exemptions and rates for married couples, single individuals, and unmarried heads of household. To reduce the work disincentive caused by taxation of secondary earners at marginal rates determined by the income of a spouse, the plan proposes that only 75 percent of the first \$10,000 of earnings of secondary workers be included in the tax base. Alternative treatments of the filing unit consistent with the general principles of a comprehensive income base are presented.

The report discusses the issues in the choice between exemptions and tax credits as adjustments for family size, and recommends a per-member exemption instead of a credit. However, it is noted that various methods of adjusting for family size, including use of credits, are fully consistent with the comprehensive income base.

The report shows how adoption of the recommended changes in the tax base would change tax rates. With an exemption of \$1,000 per taxpayer and an additional \$1,600 per tax return, it is possible under the comprehensive income tax to raise the same revenue with roughly the same distribution of the tax burden by income class as under the present income tax, using only three rate brackets, ranging

from 8 percent in the lowest bracket, to 25 percent for middle income taxpayers, to 38 percent for upper income taxpayers. The generous \$1,000 personal exemption (instead of \$750 under present law) plus an additional \$1,600 exemption per return helps provide the same ability-to-pay distribution of the tax burden as present law. Alternatively, it is possible to raise the same revenue under the comprehensive income tax with a flat rate of slightly over 14 percent on all income if there are no exemptions and with a flat rate of slightly under 20 percent with exemptions of \$1,500 per taxpayer.

In summary, the comprehensive income tax proposal is a complete plan for a major rebuilding of the tax system that eliminates many of the inconsistencies in the present tax code. The plan clearly demonstrates the feasibility of major improvements in the simplicity, efficiency, and fairness in the income tax.

CASH FLOW, CONSUMPTION BASE TAX

Consumption is less widely advocated than income in discussions of tax reform but it deserves serious consideration as an alternative ideal for the tax base. A consumption tax differs from an income tax in excluding savings from the tax base. In practical terms, this means that net saving, as well as gifts made, are subtracted from gross receipts to compute the tax base. Withdrawals from savings, and gifts and bequests received but not added to net savings, are included in gross receipts to compute the tax base.

Advantages of a Consumption Base

The report shows that a version of a consumption base tax, called the "cash flow tax," has a number of advantages over a comprehensive income tax on simplicity grounds. The cash flow tax avoids the most difficult problems of measurement under a comprehensive income tax -- such as depreciation rules, inflation adjustments, and allocation of undistributed corporate income -- because all forms of saving would be excluded from the tax base.

In addition, the report demonstrates that the cash flow tax is more equitable because it treats alike all individuals who begin their working years with equal wealth and the same present value of future labor earnings. They are treated differently under an income tax, depending on the time pattern of their earnings and the way they choose to allocate consumption expenditures among time periods.

By eliminating disincentives to saving, the cash flow tax would encourage capital formation, leading to higher growth rates and more capital per worker and higher before-tax wages.

How a Consumption Base Could be Taxed

According to one method of designing a consumption tax the taxpayer would include in his tax base all monetary receipts in a given time period, including withdrawals from past savings and gifts and bequests received, and exclude from his tax base current savings, gifts made, and certain itemized expenditures also allowed as deductions under the comprehensive income tax. Thus, the full proceeds of asset sales would be taxed if used for consumption rather than for purchase of other assets (including such "purchases" as deposits in savings accounts). Inclusion of asset sales and deduction of asset purchases from the tax base, make it possible for the tax base to measure an individual's annual consumption without actually tallying up his purchases of consumption goods and services.

A second method of computing the base for a tax based on consumption is to exempt all capital income from tax. Dividends, interest, capital gains, and profit from a personal business would be excluded from an individual's tax base. Interest receipts would be excluded from the base, and interest payments on loans would not be deducted. Purchases of productive assets would not be deductible, because the returns from them would not be included in the base.

These alternative treatments of assets lead to a tax base with the same present value. Deferral of tax in the present leads to payment of the same tax plus interest when the asset is sold for consumption. However, the payment of taxes occurs later under the method which allows a savings deduction than under the method which allows an interest exemption.

Similarities to the Present Tax Base

The report points out that the current tax system is closer to a cash flow tax than to a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans -- homeownership and employer contributions to retirement annuities (or contributions of individuals to Keogh Plans and IRA's) -- are treated under the current law almost

exactly the same way they would be treated under a consumption tax which allows a deduction for savings. Similarly, many of the present system's uncoordinated exclusions of capital income from tax approximate the second approach to a consumption base tax. Thus, the model cash flow tax is not as complete a change from the present tax system as it might seem.

Treatment of Investments in the Model Plan

In the model cash flow tax individuals may choose between the two essentially equivalent ways of treating investments. Purchases of assets are eligible for deduction only if made through "qualified accounts." The qualified accounts would keep records of an individual's net investment balance so that annual saving and dissaving can be measured. Each year, net contributions to qualified accounts would be computed and subtracted from the tax base. If withdrawals exceed contributions in any year, the difference would be added to the tax base. Thus, the proceeds from an investment made through a qualified account are subject to tax only when withdrawn.

Savings not deposited in a qualified account are not eligible for deduction, but the interest and capital gains from investments financed by such saving are not included in the tax base. There is no need to monitor the flow of investments or the investment income earned outside of qualified accounts because they have no place in the calculation of tax.

The report spells out the consequences of allowing a taxpayer to choose between alternative ways of being taxed on income from assets, providing specific examples of how the tax would work. It is shown how allowing two alternative treatments for both assets and loans provides a simple averaging device that would enable taxpayers to avoid the inequities associated with applying a progressive rate system to individuals with different annual variation in the level of consumption. The report also shows how allowing alternative treatment of assets and loans simplifies the measurement of the tax base.

Other Features of the Cash Flow Tax

Under the proposal, all consumer durables (such as automobiles and homes) are treated as assets purchased outside of a qualified account. No deductions are allowed for the purchase of a consumer durable, and receipts from the sale of a consumer durable are not included in the tax base.

Gifts are treated differently under the cash flow tax than under both the comprehensive income tax and the current tax system. In the cash flow tax proposal, gifts and inheritances received are included in the tax base, while gifts given are deducted. Under present income tax law and under the model comprehensive income tax the treatment is reversed, with gifts received excluded from the donee's tax base but no deduction allowed for an individual who makes a gift. It is assumed that in both systems there would continue to be a separate tax on transfers of assets by gift or bequest, such as the present estate and gift tax.

The proposal describes in detail how specific items of capital income -- dividends, interest, capital gains, income from personal business, and accumulation of retirement pensions -- are treated. The corporate income tax is eliminated because there is no longer a need to tax undistributed corporate income. Purchases of corporate stocks through qualified accounts are tax deductible, while all withdrawals from qualified accounts are included in the tax base. Sale proceeds of corporate stock, dividends, and interest, if remaining in the qualified account, are not taxed.

The cash flow tax, like the comprehensive income tax, would move towards neutrality in the tax treatment of different kinds of investments. In doing so, both proposals would have the effect of encouraging the best use of available capital. In addition the cash flow tax would eliminate the discouragement to capital formation inherent in the concept of a tax on income.

The Filing Unit and Tax Rates

The cash flow tax proposal treats definition of the filing unit, exemptions for family size, and deductions of personal consumption items the same way as the comprehensive income tax proposal. The differences between the two proposals are in the treatment of items which represent a change in net worth, or income from capital, and in the treatment of gifts and inheritances.

Under the cash flow tax, an exemption of \$800 per person and \$1,500 per return together with the three rate brackets -- 10 percent, 28 percent, and 40 percent -- would allow present tax revenues to be raised while maintaining the same vertical distribution of tax burdens.

TRANSITION PROBLEMS

Reforming the existing tax system poses a different set of problems than designing a new tax system from scratch. Although the report concentrates on the design of approximations to ideal tax systems, the problems of transition have also been examined and possible solutions embodied in specific proposals.

Transition to a new set of tax rules poses two separate, but related problems. First, changes in rules for taxing income from capital will lead to changes in the relative value of assets. Problems of fairness would exist if investors who had purchased a particular type of asset in light of the present tax system were subjected to losses by sudden major changes in tax policy. Similarly, changes in tax policy may provide some investors with windfall gains. Second, changes in the tax law raise questions of what to do about income earned before the effective date, but not yet subject to tax. For example, the comprehensive income tax, which proposes full inclusion of capital gains in the base (subject to an inflation adjustment), requires a transition rule for taxing capital gains accumulated before, but realized after, the effective date.

The report describes two methods for moderating the wealth effects of tax reform--"grandfathering," or exempting existing assets from the new tax provisions, and phasing-in of the new rules. Specific proposals for use of these instruments for projected changes in the tax code are presented. The report also outlines specific transition proposals for handling income earned before the effective date, but not yet taxed.

HOW AN INDIVIDUAL WOULD CALCULATE TAX LIABILITY UNDER THE REFORM PLANS

Elements Common to Both Plans

The method of calculating tax liabilities under the model tax systems would be similar to the method in use today. Taxpayers would fill out a form like the Form 1040, indicating family status and number of exemptions. There would not be a standard deduction under either plan. Taxpayers who had eligible deductions would choose to itemize; to reduce the number of itemizers, deductions would be subject to floor amounts.

The tax base would be calculated on the form, and the tax rate schedule appropriate to the filing unit (i.e., single, married, head of household) would be applied to compute tax liability. Taxes owed and refunds due, would depend on the difference between tax liability and taxes withheld as reported on W-2 statements or estimated tax paid.

The wages and salaries of the primary wage earner would remain the biggest item in the tax base of most households and would be entered into the calculation of income the same way as under the current system. The first \$10,000 of wages and salaries of secondary wage earners would be multiplied by .75 before being added to the tax base. The rules for calculating some deductions (e.g., child care) would be changed, and other deductions (e.g., property and gasoline taxes) would be eliminated.

The Comprehensive Income Tax

Under the comprehensive income tax, some additional items would be added to the computation of tax. Corporations would supply to all stockholders a statement of the amount of profit attributed to that stockholder in the previous year, and an adjustment to basis that would rise with earnings and fall with distributions. Similar statements of attributed earnings would be supplied to taxpayers by pension funds and insurance companies. In addition to the income reported in these statements, taxpayers would report income from interest on State and local bonds, unemployment compensation, and social security retirement benefits.

All capital gains (or losses) would be entered in full in the computation of taxable income. The basis for corporate shares would be increased by corporate income taxed but not distributed to them. In computing gains from sale or exchange, the taxpayer would be allowed to adjust the basis of assets sold for inflation. A table of allowable percentage basis adjustments would be provided in the tax form. The taxpayer would use statements received from corporations to adjust the basis of corporate shares upward for any past attributed corporate profits and downward for dividends or other distributions received.

The Cash Flow Tax

The major change under the cash flow tax is that the taxpayer would receive yearly statements of net withdrawals

or deposits from all qualified accounts. If deposits exceeded withdrawals, the difference between deposits and withdrawals would be subtracted from the tax base. If withdrawals exceeded deposits, the difference would be added to the tax base.

Interest, dividends, and capital gains realized on investments made outside of qualified accounts would not be reported on the tax form and would not be included in taxable income. The rationale for this is that the tax would have been pre-paid, because no deduction was allowed at the time of purchase.

Gifts and inheritances received would be included in the tax base (but if deposited in a qualified account would have an offsetting deduction). A deduction would be allowed for gifts and bequests given. The identity of the recipient of deductible gifts would be reported on the donor's return.

CHAPTER-BY-CHAPTER OUTLINE OF THE REMAINDER OF THE REPORT

Chapter 2 -- What is to be the Tax Base?

Chapter 2 reviews the main issues in choosing an appropriate tax base (the sum to which the structure of exemptions and rates is applied) and presents the case for considering a cash flow tax based on consumption as an alternative to a reformed comprehensive income tax. General issues of equity in design of a tax system are discussed, and the concepts of consumption and income are explained in detail. It is shown that the current tax system contains elements of both a consumption base and a comprehensive income base. Thus, it is shown how the adoption of a consumption or cash flow tax would not be as great a change from the present system as it might seem. The alternative tax bases are compared on grounds of equity, simplicity, and effects on economic efficiency.

Chapter 3 -- A Model Comprehensive Income Tax

A model comprehensive income tax is presented in chapter 3. The major innovations in the plan relate to integration of the corporation and individual income taxes, and to tax treatment of capital gains, State and local bond interest, income accumulated in pensions and life insurance funds, retirement income, and unemployment compensation. Changes in many personal deductions are suggested. Important recommendations for changes in the filing unit, adjustment for

family size, and taxation of secondary wage earners are set forth. International considerations in income taxation are discussed briefly. The chapter concludes with a description of a sample form for tax calculation under the comprehensive income proposal.

Chapter 4 -- A Model Cash Flow Tax

In chapter 4, a model cash flow tax based on consumption is presented. The major innovation in the cash flow tax is that savings may be deducted from the tax base. The use of qualified accounts to measure the flow of saving and consumption is proposed. The equivalence between deductibility of saving and exclusion of capital earnings from tax is explained, and alternative treatments of assets reflecting this equivalence are presented. Treatment of specific items under the model cash flow tax is proposed in detail and compared with treatment of corresponding items under the comprehensive income tax. Arguments against the cash flow tax on grounds of progressivity and effects on wealth distribution are evaluated. The use of a supplementary wealth transfer tax to provide greater progressivity is explored. The chapter concludes with a description of a sample tax form under the cash flow proposal.

Chapter 5 -- Quantitative Analyses

Chapter 5 presents simulations of the effects of the proposed reforms on the tax liabilities of different groups of taxpayers. The chapter demonstrates that the vertical structure of tax burdens under the present income tax system may be broadly duplicated with a more generous set of exemptions and a rate schedule which is more moderate and much simpler so long as the tax base is greatly broadened as proposed under either the comprehensive income tax (chapter 3) or the cash flow consumption type tax (chapter 4).

Chapter 6 -- Transition Considerations

Chapter 6 proposes transition rules to accompany adoption of the model tax plans. Problems which may arise in changing tax laws are explained, and instruments to ameliorate adjustment problems, including exempting existing assets from changes and phasing in new rules, are described and evaluated. Specific proposals are presented for transition to both a comprehensive income base and a cash flow base that cover the timing of the application of new rules to specific proposed changes in the tax code.

Table 1

Summary Comparison of Model Tax Plans

Item	Current tax	Model Comprehensive income tax	Model cash flow tax
Corporate income			
a. Retained earnings	Separately taxed to corporations	Attributed to individuals as income and included in tax base	No tax until consumed
b. Dividends	Separately taxed to corporations, included in individual tax base with \$100 exemption	Not taxed separately	No tax until consumed
Capital gains	50% of long-term gains included when realized; alternative tax available	Fully included in tax base on realization; no partial exclusion	No tax until consumed
Capital losses	50% of long-term losses deductible against included portion of long-term gains and \$1,000 of ordinary income; carryover of losses allowed	Fully deductible from tax base on realization	No tax offset unless consumption is reduced
Depreciation	Complex set of depreciation rules for different types of equipment and structures	Reformed rules for depreciation; depreciation to approximate actual decline in economic value on a systematic basis by industry classes	Permits expensing of all business outlays, capital or current

Table 1
Summary Comparison of Model Tax Plans
(continued)

Item	Current tax	Model comprehensive income tax	Model cash flow tax
State and local bond interest	Excluded from tax base	Included in tax base	Excluded from tax base until consumed
Other interest received	Included in tax base	Included in tax base	Excluded from tax base until consumed
Proceeds of loans	Excluded from tax base	Excluded from tax base	Inclusion in tax base optional
Interest paid on loans	Deducted from tax base	Deducted from tax base	Deducted from tax base if proceeds of loan included in base
Principal repayments on loans	Not deducted from tax base	Not deducted from tax base	Deducted from tax base if proceeds of loan included in base
Rental value of owner-occupied homes	Excluded from tax base	Excluded from tax base	Implicitly included in tax base because purchase treated as consumption
State or local property, sales and gasoline taxes (non-business)	Deducted from tax base	Not deducted from tax base	Not deducted from tax base
Medical expenses <u>1/</u>	Expenses over 3% of adjusted gross income deducted from tax base	No deduction; possible credit for expenses over 10% of income*	No deduction; possible credit for expenses over 10% of consumption*
Charitable contributions <u>2/</u>	Deducted from tax	Not deducted from base*	Not deducted from tax base*

Table 1
Summary Comparison of Model Tax Plans
(continued)

Item	Current tax	Model comprehensive income tax	Model cash flow tax
Casualty losses	Uninsured losses deducted from tax base*	Not deducted from tax base*	Not deducted from tax base
State and local income taxes	Deducted from tax base	Deducted from tax base*	Deducted from tax base*
Child care expenses <u>3/</u>	Limited tax deduction	Revised tax deduction*	Revised tax deduction*
Contributions to retirement pensions	Employer contributions untaxed; employee contributions taxed	All contributions excluded from tax	All contributions excluded from tax
Interest earnings on pension funds	Excluded from tax	Attributed to employer or to individuals and taxed in full as accrued	Excluded from tax
Retirement benefits from pension funds	Included in tax base except for return of employee contribution	Included in tax base	Included in tax base unless saved
Social security contributions	Employer contributions untaxed; employee contributions taxed	All contributions excluded from tax	All contributions excluded from tax
Social security retirement income and unemployment compensation	Excluded from tax base	Included in tax base	Included in tax base unless saved
Wage and salary income <u>4/</u>	Included in tax base	Included in tax base for primary earner; for secondary earners, 75% of wages under \$10,000 and all wages over \$10,000 included*	Included in tax base for primary earner; for secondary earners, 75% of wages under \$10,000 and all wages over \$10,000 included*; savings out of wages deductible

Table 1

Summary Comparison of Model Tax Plans
(continued)

Item	Current tax	Model comprehensive income tax	Model cash flow tax
Deposits in qualified investment accounts	No tax consequences	No tax consequences	Deducted from tax base
Withdrawals from qualified investment accounts	No tax consequences	No tax consequences	Included in tax base
Standard deduction	Available to non-itemizers only; \$1,600 or 16% of adjusted gross income up to \$2,400 for single taxpayer, \$1,900 or 16% of adjusted gross income up to \$2,800 for married couple filing jointly	No standard deduction; \$1,600 per return exemption	No standard deduction; \$1,500 per return exemption
Personal exemptions	\$750 per individual; extra exemptions for aged and blind	\$1,000 per individual	\$800 per individual

Office of the Secretary of the Treasury
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* Indicates alternative treatments possible.

- 1/ Medical deduction optional under model tax plans. Alternative ways of structuring deduction or credit possible.
- 2/ Charitable deduction optional under model tax plans. Other alternatives possible, including limited credit.
- 3/ Child care deduction and its form and limits optional under model tax plans.
- 4/ Treatment of secondary earners optional under model tax plans.